No. 9891

# In the United States Circuit Court of Appeals for the Ninth Circuit

PEERLESS STAGES, INC., A CORPORATION, PETITIONER

*v.*

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

*ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS*

## BRIEF FOR THE RESPONDENT


SAMUEL O. CLARK, Jr.,
*Assistant Attorney General.*

J. L. MONARCH,
HARRY MARSELLI,
*Special Assistants to the Attorney General.*

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# In the United States Circuit Court of Appeals for the Ninth Circuit

No. 9891

Peerless Stages, Inc., a Corporation, petitioner

*v.*

Guy T. Helvering, Commissioner of Internal Revenue, respondent

*ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS*

## BRIEF FOR THE RESPONDENT

### OPINION BELOW

The only previous opinion is that of the Board of Tax Appeals (R. 94–98), which is reported at 43 B. T. A. 111.

### JURISDICTION

This petition for review involves deficiencies in income and excess profits taxes for the year 1936, in the respective amounts of $25,289.85 and $9,609.39, and is taken from a decision of the Board of Tax Appeals entered December 20, 1940. (R. 98–99.) The case is brought to this Court by a petition for review filed March 11, 1941 (R. 99–106), pursuant to the provisions of Sections 1141–1142 of the Internal Revenue Code.

## QUESTION PRESENTED

Whether the excess of the cost of operation of certain bus transportation lines over receipts therefrom in prior years may be capitalized by the taxpayer and used as its basis for computing gain from the "sale" thereof in 1936, or whether those operating losses were deductible only in their respective years.

## STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations may be found in the Appendix, *infra,* pp. 23–30.

## STATEMENT

The facts found (R. 94–96) by the Board of Tax Appeals, from testimony and exhibits adduced in evidence before it (R. 28–94), may be stated as follows:

The petitioner, Peerless Stages, Inc. (hereinafter referred to as the taxpayer), is a California corporation organized in 1923 and having its principal office in Oakland. It had taken over, when organized (R. 41–42), a bus transportation system between Oakland, Palo Alto, San Jose, and Santa Cruz (California), which four individuals had theretofore been operating under a certificate of the California State Railroad Commission. The four individuals became its only stockholders and were four of its five directors. (R. 94–95.)

The area between Oakland and Hayward contained much orchard and tomato land about 1931. For several years before 1931, a street car line had been operated (by others) between those points, and the taxpayer was

giving it intermediate bus service as a part of its inter-city service between Oakland and San Jose. The taxpayer considered two alternative plans for providing the area with transportation, one, a skeleton service which would merely take care of the existing demand, and the other, a more frequent service at twenty-minute intervals. The taxpayer adopted the twenty-minute service plan and in 1931 established a local service between Oakland and Hayward (along East 14th Street), under which the buses stopped at any corner to take on or discharge passengers. In addition, the taxpayer continued its inter-city service over that route. The area developed rapidly. (R. 95.) ~~(See R. 43–47.)~~

In 1933, the taxpayer filed with the State Railroad Commission an application for authority to extend its local bus service to the Castro Valley and San Lorenzo areas (two areas lying a little to the north and south, respectively, of its Oakland-to-Hayward route along East 14th Street). Authority was granted and in 1934 the taxpayer instituted a new local service to those areas, on a twenty-minute frequency, and that new service, coordinated with the existing local service, resulted in ten-minute service to certain areas (along East 14th Street). (R. 95.)

A summary of the results of the operation of the two new local services above mentioned, showing the miles traveled, the passenger and express receipts, the yearly loss from operation of the new local service, computed by deducting from transportation revenues the transportation expenses, self-insurance charges, and depre-

ciation adjustments, is shown in the following table (R. 96):[1]

| | Miles | Receipts | Loss |
|---|---|---|---|
| 1931 | 282, 127 | $48, 356. 91 | $15, 613. 54 |
| 1932 | 328, 860 | 58, 230. 04 | 11, 230. 94 |
| 1933 | 342, 513 | 63, 355. 05 | 516. 47 |
| 1934 | 753, 967 | 101, 640. 22 | 39, 459. 22 |
| 1935 | 839, 046 | 108, 550. 72 | 52, 885. 41 |
| Total | | | 119, 705. 58 |

In 1935, the taxpayer's directors contemplated abandoning the new local routes to another transportation company, and on January 14, 1936, a contract to that end (R. 17–25) was entered into between the taxpayer and the Railway Equipment & Realty Company, Ltd., (under which the taxpayer agreed to abandon its service on the new local routes, it being contemplated that service thereon would be rendered thereafter by East Bay Street Railways, Ltd., a corporation owned by the equipment company). Under it the taxpayer also sold fifteen of its buses. The consideration under the con-

[1] This table represents (to the exclusion of all of the taxpayer's other services) (the total results of the operation of the two new services, the first one being the local service along East 14th Street and represented on the table in the figures for the years 1931, 1932 and 1933; the second one being the local service to the Castro Valley and San Lorenzo areas, started in 1934 and reflected in the figures set out in the table for the years 1934 and 1935. Itemized statements showing, both as to the new services and as to all other services of the taxpayer, the transportation revenues, and the transportation expenses, consisting of the various items expended for conducting transportation, maintenance, traffic, and miscellaneous matters, for the years 1931 to 1935, inclusive, are set out in detail in the record. (Exhibits Nos. 2 to 6, both inclusive, R. 53–65.)

tract was $180,000, plus $30,000 designated as reimbursement for the taxpayer's local service operating deficit from April 1 to December 31, 1935, and an additional sum for the taxpayer's local service operating deficit from January 1, 1936, to the date of the actual abandonment of the local service (R. 96)—the total received by the taxpayer being $216,540.32 (R. 5).

On its income tax returns for the years 1931 to 1934, inclusive, the taxpayer had deducted from its current income for each of the years the losses from the operation of the new routes. On May 21, 1936, the taxpayer filed amended returns for those four years, and on them, and also on the return filed for 1935, it treated the losses resulting from the operation of the new routes (aggregating $119,705.58) as having been capitalized. (R. 96.)

In its income tax return for the year 1936, in reporting its capital gain resulting from the transaction (under its contract for the abandonment of its local service routes), the taxpayer reported a capital gain of $92,334.74,[2] by including in its basis the $119,705.58 of aggregate losses from the operation of the local services in question for the years 1931 to 1935, inclusive (R. 96–97).

The Commissioner, in his audit, increased the amount of the gain from the transaction to $212,040.32, by eliminating the $119,705.58 from the basis, holding that the operating losses of the years 1931 to 1935, inclusive, could not be capitalized. The Commissioner, accord-

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[2] This figure is erroneously given as $92,234.14 in the Board's opinion (R. 96), but see R. 15.

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ingly, determined deficiencies in income and excess profits taxes for the year 1936. (R. 12–17, 97.)

From the Commissioner's determination, the taxpayer appealed to the Board of Tax Appeals, contending that the excess of the operating expenses over operating receipts from the new routes in question constituted capital expenditures, which were not properly deductible in the year of operation. (R. 3–11.) The Board of Tax Appeals upheld the action of the Commissioner (R. 97–98), and sustained the deficiencies asserted against the taxpayer (R. 98–99).

The taxpayer brings the question thus presented to this Court for review. (R. 99–106.)

## SUMMARY OF ARGUMENT

In determining the gain from the "sale" of the bus lines in question in 1936, the taxpayer is not entitled to capitalize and use as part of its basis the losses from the operation of those routes during the prior years of 1931 to 1935, inclusive. The losses of the earlier years which the taxpayer is seeking to capitalize are merely the excess of the expenses of operation over the receipts therefrom during the prior years. The expenses in question consisted entirely of expenses clearly attributable to current operation, and they were currently deductible from income in the respective earlier years of operation. Hence, they cannot be capitalized in the year of "sale" and be used to reduce the profit resulting from the "sale."

Moreover, since the taxpayer did not *sell* the routes in question nor its so-called "operative rights"—but merely agreed to abandon them—it is not in any event

entitled to use any basis in respect of them, because under the statute a basis may be used only in the case of a "sale or other disposition" of property.

## ARGUMENT

**The losses resulting from the operation of certain bus lines in earlier years cannot be capitalized and used as the basis for determining gain from the "sale" thereof in the taxable year**

During the taxable year 1936 the taxpayer, under a contract with the Railway Equipment and Realty Company, Ltd., agreed to abandon its local service routes in question and transferred certain buses. (R. 17–25, 96.) The total consideration received by the taxpayer under that contract was $216,540.32. (R. 5.) In reporting its profit on that transaction, the taxpayer, in its 1936 return, reported a capital gain of $92,334.74. (R. 15.) The Commissioner, in his determination, increased the amount of the gain to $212,040.32. (R. 15, 96–97.) Thus, the difference between the respective computations of profit by the parties amounts to $119,705.58, and upon that difference the present controversy is centered. The only dispute between the parties is whether, in computing its gain under the contract, the taxpayer is entitled to capitalize and use as part of its cost basis the total of $119,705.58 of the losses from the operation of the services in question during the prior years of 1931 to 1935, inclusive. The taxpayer contends that the operating losses of the prior years may be capitalized and used as part of its basis in computing the profit. The Board of Tax Appeals, sustaining the position of the Commissioner, held that since the losses in question con-

sisted entirely of operating expenses, they could only be deducted in the respective years of operation and could not be capitalized and be used to compute the profit. (R. 96–98.) We submit that the decision of the Board of Tax Appeals is unquestionably correct and should, therefore, be affirmed.

Under our system of income taxation upon the basis of annual periods (*Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359), provision is made in the statute for the deduction, in arriving at taxable net income, of all the ordinary and necessary expenses of carrying on a trade or business. Section 23 (a) of the Revenue Act of 1936, Appendix, *infra.* A similar provision is contained in the earlier Revenue Acts applicable to all of the earlier years of operation here involved. Section 23 (a) of the Revenue Acts of 1928, 1932 and 1934. Under the applicable Regulations, those "ordinary and necessary expenses" of carrying on a trade or business, allowed by the statute as deductions in the computation of net income, have been defined and described in greater detail under the general heading of "Business Expenses." Article 23 (a)–1 of Regulations 94 (promulgated under the Revenue Act of 1936), Appendix, *infra.* The earlier Regulations contained similar provisions. Article 23 (a)–1 of Regulations 86 (promulgated under the Revenue Act of 1934), Article 121 of Regulations 77 (promulgated under the Revenue Act of 1932), and Regulations 74 (promulgated under the Revenue Act of 1928). In addition, in laying down the pattern to be used in the computation of the annual taxable net income, the statutes have specifically provided that no

deduction should be allowed in respect of amounts paid for new buildings or permanent improvements or betterments to property. Section 24 (a) (2) of the Revenue Act of 1936, Appendix, *infra,* and of the Revenue Acts of 1934, 1932, and 1928. Under this statutory provision, the Regulations have stated, generally, under the heading of "Capital Expenditures," that amounts paid for increasing the capital value of property are not deductible from gross income, and have enumerated in detail several examples of expenditures which are to be regarded as capital expenditures, not deductible from current income. Article 24–2 of Regulations 94, Appendix, *infra,* Article 24–2 of Regulations 86, and Article 282 of Regulations 77 and 74. In keeping with this statutory pattern for the computation of current annual income, further provision is made in the statute for an adjustment on account of expenditures chargeable to capital account, to be made to the cost or other basis of property which is to be used in the computation of gain or loss from the sale or other disposition of property. Section 113 (b) (1) (A) of the Revenue Act of 1936, Appendix, *infra.*

Thus, under the statutory scheme for the taxation of income, an annual computation of the income is to be made, under which computation the deduction of the expenses attributable to the current operation or *carrying on* of the business is currently permitted, while no deduction is permitted to be made from the current gross income for items which represent capital expenditures. Quite obviously, under that scheme, items which represent expenditures for the current operation of the

business cannot be capitalized, just as, conversely, capital items cannot be charged against current income as part of the cost of operation. Of course, to the extent that capital expenditures are made for depreciable or depletable assets, a deduction is allowed annually against current income of a proportionate part of the item, spread over its estimated life, by way of a depreciation or depletion allowance. Section 23 (l) and (m) of the Revenue Act of 1936.

In general, a capital expenditure is an outlay which is made to acquire some property, the usefulness of which in the business will last more than the current taxable year. See *LaBelle Iron Works* v. *United States,* 256 U. S. 377, 388; *Home Trust Co.* v. *Commissioner,* 65 F. (2d) 532 (C. C. A. 8th), and *A. Giurlani & Bro. Inc.* v. *Commissioner,* 119 F. (2d) 852, 857–858 (C. C. A. 9th). The best illustrations of capital expenditures are amounts expended for such things as plant construction, machinery, equipment, furniture and fixtures, etc. See Article 41–3 of Regulations 94, Appendix, *infra.* Quite obviously, such items are not to be deducted from current income because their usefulness in the business will last for more than the current taxable year, and they are, therefore, charged to capital account or capitalized. Whether a particular expenditure is a capital one or whether it represents an ordinary operating expense depends upon the nature of the expenditure. *Crocker First Nat. Bank* v. *Commissioner,* 59 F. (2d) 37, 39 (C. C. A. 9th), and *Parkersburg Iron & Steel Co.* v. *Burnet,* 48 F. (2d) 163, 165 (C. C. A. 4th). In other words, in resolving the problem, it must be borne in mind that the question of

whether a particular expenditure is an ordinary expense of operation or one for the acquisition of a capital asset is a question to be determined from the circumstances and the nature of the expenditure itself.

When consideration of the instant case is approached with these principles in mind, it is obvious at the very outset that the losses from the operation of the local routes during the earlier years, which the taxpayer is seeking to capitalize, are clearly not capital expenditures. The losses which the taxpayer is seeking to capitalize are merely the excess of the operating expenses over the operating receipts from the routes in question during the prior years. (R. 97.) When the items of the expenditures made by the taxpayer during those earlier years are individually analyzed, it is clear, beyond any shadow of a doubt, that they constitute mere expenses of current operation—all of which stand out in clear distinction from and bold contrast to capital expenditures. There is certainly nothing of a "capital" nature in any of the expenditures in question made for drivers' wages, gasoline, oil, service car expenses, station salaries, station expenses, shop expenses, miscellaneous transportation expense, etc. (R. 81.) An examination of the statements for the years 1931 to 1935, inclusive, wherein the expenses in question are itemized (R. 53–65), definitely establishes that the losses which are sought to be capitalized by the taxpayer consist of nothing more than items clearly attributable to current operation (R. 80–82).

The mere fact that the payment of those current operating expenses by the taxpayer during the earlier years had the result of building up a good business,

with a valuable good will as a going enterprise, as the taxpayer argues (Br. pp. 10, 12–13), does not change the character of the expenses to capital items, we submit. Every operating expense made in carrying on a business, new or old, has more or less the same result of building up a valuable business—or, at least, is calculated to build up a valuable business, and is obviously generally made with such hope or expectation. For example, every item of the expenses of conducting a merchandising store, such as rent, clerk hire, etc., may generally be regarded as contributing to the building up of a valuable business and good will. However, it could hardly be said that those items of operating expenses would acquire a "capital" nature for the purposes of computing taxable income. As has been seen, for tax purposes, expenditures must be classified (as between operating and capital) according to their true nature. Quite obviously, the excess of operating expenses over receipts cannot acquire the nature of capital expenditures merely because the operating expenses had the result of building up a valuable business. If the operating expenses of the taxpayer were ordinary current business expenses when made during the years 1931 to 1935, they must retain their character of operating expenses—and they cannot be changed to capital expenditures in 1936 merely because of the realization of the fact that they had succeeded in building up a valuable business.

The unique and somewhat far-fetched treatment of its earlier operating expenses contended for by the taxpayer seems to be predicated upon the proposition that

its directors realized, when the frequent local service was entered into, that it would be operated at a loss until the business developed sufficiently. (Br. 9, 12.) But even such a realization does not warrant any exceptional treatment of the taxpayer's operating expenses of the earlier years, we submit. That same circumstance might, and perhaps does, exist in the case of almost all new businesses. A person starting a new retail store, for example, may well realize that his operating expenses may exceed his profits from sales at first, until the business develops, but that does not change the character of his operating expenses—they must remain operating expenses, and cannot be capitalized. Nor should any different result follow in the instant case merely because here the taxpayer had two alternative courses to follow in the starting of these new local services: the first, the skeleton service which would have been adequate to take care of the existing needs of the territory and which would probably have shown no loss, or even a small profit, and the other, the frequent service which, it was realized, would show losses until the business developed. (See Pet. Br. 9, 12, 16 and R. 75, 77–78.) This same choice of alternatives might confront every person establishing a new business, but it in no way justifies the changing of operating expenses to capital expenses. The mere fact that more drivers are employed than are presently needed at first to meet the current requirements of the territory (Cf. R. 82) quite obviously would not make the expenses for the

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additional salaries take on a character of capital expenditures, we submit.

No merit is accorded to the taxpayer's unique claim for capitalizing earlier operating expenses by the fact that the operation of the routes in question took place under authority of the State of California. It must be borne in mind, first of all, that the permission to operate the services was not an exclusive right or franchise (R. 30) and that, in fact, others could and did engage in operations in the same areas (R. 31, 79). But, in any event, the presence of a permit or an operating franchise would not authorize the taxpayer to capitalize current expenses of operation.

In final analysis, the position of the taxpayer seems to be no more than a contention that the earlier operating losses of its business in question can be capitalized because they constituted "development expenses," in that they resulted in building up a valuable business or right. (Br. 12, 16.) Of course, it is immaterial here whether for other purposes the early operating losses of a business might be regarded as development expenses and be capitalized as such. It may be true that there is some support for the taxpayer's theory of capitalizing early operating deficits in some of the so-called "rate" cases. While we see no occasion to indulge in an exhaustive analysis of the authorities in that field, it may be observed in passing that the Supreme Court has held that past deficits from operations during earlier years could not be included as development cost in the base value for the purpose of deter-

mining whether a rate is confiscatory. *Galveston Elec. Co.* v. *Galveston,* 258 U. S. 388, 392–397.[3]

But, regardless of how they might be treated for other purposes, the operating losses of earlier years cannot be capitalized for income tax purposes, we submit. The controlling consideration here is that the expenses of current operation of a business are currently deductible from income under our income tax law, and they may not be capitalized. As we have already observed, in the field of income taxation a capital expenditure is an amount paid out for something of a more or less permanent use in a business (*Crocker First Nat. Bank* v. *Commissioner,* 59 F. (2d) 37, 39 (C. C. A. 9th), and *LaBelle Iron Works* v. *United States,* 256 U. S. 377, 388), as contrasted to amounts paid out for "carrying on" the business, which are currently deductible under Section 23 (a) of the statute. The true test, in each substance, is "the nature of the expenditure in and of itself." *Parkersburg Iron & Steel Co.* v. *Burnet,* 48 F. (2d) 163, 165 (C. C. A. 4th.) Under that test, all of the expenses in the earlier years here involved were ordinary operating expenses, and they were, therefore, currently deductible from income in the respective years of operation—and they cannot be capitalized. This result must follow, notwithstanding the claim that the earlier expenses resulted in building up a valuable business or right in the taxpayer. As

[3] In so holding, the Supreme Court refused to follow the so-called Wisconsin rule of such cases as *Hill* v. *Antigo Water Co.*, 3 Wis. R. Comm. Rep. 623, 713, 723, quoted by the taxpayer in its brief (pp. 14–15.)

we have already suggested, the expenses of carrying on any new business might similarly be claimed to be "development expenses" on the ground that they contributed to building up the business and to creating an asset of value, good will or going-concern value. In that respect, the taxpayer's situation is no different from that of any other business and the taxpayer is entitled to no different treatment under the tax laws upon the basis of any such claim. The taxpayer cannot capitalize what were merely ordinary operating expenses of earlier years—no more than any other business man or merchant could capitalize the earlier operating losses of his business.

It is, of course, true that under our scheme of income taxation some provisions are made for taking into account so-called development expenses in some special cases. For example, in dealing with the subject of depletion in the case of oil and gas wells, it is provided that so-called "intangible" drilling and development costs may be deducted as current expenses or may be charged to capital account, at the taxpayer's option. Article 23 (m)–16 of Regulations 94. In dealing with depletion in the case of mines, it is provided that expenditures in the development stage may be charged to capital account. Article 23 (m)–15 of Regulations 94. Likewise, in the case of timber, provision is made for the recovery of cost of development through depreciation. Article 23 (m)–23 of Regulations 94. As to patents, depreciation is allowed based on cost, including development or experimental expenses. Article 23 (*l*)–7 of Regulations 94. It is further recognized that

depreciation may be taken in respect of intangibles used in a business which have a limited life, such as patents and trademarks, licenses and franchise, while no depreciation may be taken of intangibles which do not have a limited life. Article 23 (*l*)–3 of Regulations 94. But no deduction for depreciation, including obsolescence, is allowable in respect of good will. Article 23 (*l*)–3 of Regulations 94. See *Red Wing Malting Co.* v. *Willcutts,* 15 F. (2d) 626 (C. C. A. 8), certiorari denied, 273 U. S. 763. Although many capital expenditures may, because of their nature, be recovered through annual charges against income, or by depreciation allowances, etc., it is quite clear that not all capital expenditures may be amortized or charged back against income. See *Surety Finance Co.* v. *Commissioner,* 77 F. (2d) 221 (C. C. A. 9th.)

In the instant case, the taxpayer, as the Board properly recognized in its opinion (R. 97–98), may possibly have been entitled to capitalize some of the expenses in the earlier years if it had specifically identified them as expenses attributable to capital, as has been held in certain cases in respect of the cost of solicitation of new business, or of increasing the circulation of a newspaper, etc. Cf. *Houston Natural Gas Corp.* v. *Commissioner,* 90 F. (2d) 814 (C. C. A. 4th), certiorari denied, 302 U. S. 722; *Meredith Pub. Co.* v. *Commissioner,* 64 F. (2d) 890 (C. C. A. 8th), certiorari denied, 290 U. S. 646; *Willcutts* v. *Minnesota Tribune Co.,* 103 F. (2d) 947 (C. C. A. 8th), and *News Pub. Co.* v. *Blair,* 29 F. (2d) 955 (App. D. C.) That involves simply a recognition of the fact that a capital expenditure may be one

made for intangible assets, including good will, as well as one made for tangible assets, such as machinery or furniture, etc. See *Newspaper Printing Co.* v. *Commissioner,* 56 F. (2d) 125 (C. C. A. 3d.) But, as the Board pointed out (R. 97, 98), the taxpayer here failed to identify any of its expenditures of the earlier years as capital items. To simply claim that the entire excess of cost of operation in the earlier years over receipts therefrom was a capital expenditure obviously is not enough. In view of the burden which was on the taxpayer (*Welch* v. *Helvering,* 290 U. S. 111, 115), it was incumbent upon the taxpayer to establish specifically which, if any, of the earlier expenditures were attributable to capital instead of operation. See *Surety Finance Co.* v. *Commisisoner, supra,* p. 224, and *Meredith Pub. Co.* v. *Commissioner, supra,* p. 893. Therefore, in any event, under the rule recognized in these authorities, since the taxpayer failed to establish which, if any, of the earlier expenditures were capital expenditures, the denial of the right to capitalize the entire amount must be sustained. See *Houston Natural Gas Corp.* v. *Commissioner, supra,* p. 817.

In this connection, we may point out that, because of the very nature of the problem involved, cases involving the classification of expenses are indeed difficult to harmonize, and that each case must turn upon its own particular circumstances. See *Welch* v. *Helvering, supra,* p. 115; cf. *Gaylord* v. *Commissioner,* 41 B. T. A. 1119; *First National Bank of Skowhegan* v. *Commissioner,* 35 B. T. A. 876; *Bretzfelder* v. *Commissioner,* 21 B. T. A. 789; cf. also *A. Giurlani & Bro., Inc.* v. *Commissioner, supra.*

As we have shown, the general scheme of income taxation upon the basis of annual periods calls for charging against current income all of the expenses of *operation* of the business, so that each year's computation will truly reflect the income for that year. Capital expenses cannot be charged against current income, and current operating expenses cannot be capitalized. This is made all the more clear by the additional provision of the statute that deductions must be taken in the year in which paid or incurred (Section 43 of the Revenue Act of 1936, Appendix, *infra*), and by the further provision of the Regulations that the expenses or the deficit of one year cannot be used or carried forward to the next year. Article 43–1 and 43–2 of Regulations 94, Appendix, *infra*.

In other words, the taxpayer was obliged to take these deductions for the operating expenses of the earlier years in those earlier years, when they were paid or incurred, and cannot carry them forward to the taxable year 1936, either as part of its basis or in any other manner.

It may be observed in passing that the taxpayer here had properly currently deducted the operating expenses of the earlier years in computing its income in the respective years of operation, in its returns for the years 1931 to 1934, inclusive. (R. 96.) The attempted change in the treatment of those operating expenses significantly came about after the taxpayer had made the "sale" in question in January of 1936. (R. 96.) It was only after the "sale" that amended returns were filed for the years 1931 to 1934, in which the operating losses were capitalized, and additional taxes paid. (R.

85.) As a matter of fact, the record shows that after the "sale" came up for consideration, the directors of the taxpayer "felt that there was going to be quite a tax problem involved." (R. 71.) Then Mr. Weiser, auditor and secretary of the taxpayer (R. 40–41), looked into the problem (R. 72), and apparently produced this unique but advantageous plan for handling it—namely, this theory of capitalizing early operating deficits as development costs. By the paying of additional taxes (R. 7) of $101.40 for 1931, $2,415.94 for 1932, and $3,269.22 for 1934, and by capitalizing the $52,885.41, operating loss for 1935 (R. 96), the taxpayer's plan for this change of treatment of the expenses of the earlier years would reduce the gain from the transaction by more than $119,000, and would effect a savings of the taxes involved in the present controversy, amounting to almost $35,000—if successful. But we submit, the Board of Tax Appeals properly refused to permit this change of treatment and properly held that the operating expenses of the earlier years were deductible only in the respective years of operation. We might point out, further, that that decision inflicts no injury or loss upon the taxpayer, because the taxpayer protected itself against loss by filing claims for the refund of the overpayments which would result as to the earlier years if the taxpayer is unsuccessful in its claim in the present proceeding. (R. 33–35, 83–84.)

In conclusion, we submit that the decision of the Board, sustaining the determination of the Commissioner as to the proper treatment of the expenses of

operation for the earlier years, is eminently sound and correct on the present record, and should, therefore, be sustained. Even if there were any doubt about the matter—which there obviously is not—the action of the Commissioner should be upheld, not only because of the presumption of correctness which ordinarily attaches to it, but also because the matter involved is one of accounting, over which the Commissioner has broad discretionary powers to make changes so as to clearly reflect the taxpayer's income. Section 41 of the Revenue Act of 1936, Appendix, *infra;* See *Lucas* v. *American Code Co.,* 280 U. S. 445. See also *Chicago & N. W. R. Co.* v. *Commissioner,* 114 F. (2d) 882 (C. C. A. 7th); *Huntington Securities Corp.* v. *Busey,* 112 F. (2d) 368 (C. C. A. 6th); *Schram* v. *United States,* 118 F. (2d) 541 (C. C. A. 6th.)

Moreover, entirely aside from the foregoing, there is an additional reason for the affirmance of the decision of the Board in the instant case. The Board refused to permit the capitalizing of the losses of earlier years as part of the basis under Section 113 (b) (1) (A) of the statute for determining the gain "from the sale or other disposition of property" under the contract in question. If the taxpayer has made no "sale or other disposition," the decision of the Board denying the right to use the earlier losses as "basis" is in any event correct, because a "basis" may be used under the statute as an offset against "the amount realized" only in the case of a "sale or other disposition of property." In other words, if the transaction was not a "sale or other disposition," the taxpayer in any event is not

entitled to capitalize any amounts as basis or to use any basis at all. The taxpayer is attempting to use the earlier losses as the basis for its so-called "operative rights." But the taxpayer, under the contract, sold only the 15 buses, the basis of which is not involved in the present controversy. It did not sell or dispose of its "operative rights" to the Equipment company. It merely agreed to abandon its local service routes. (R. 19.) It could not and did not sell or transfer them or the right to operate them to the Equipment company—only the State Railroad Commission could grant permission to operate. Therefore, the taxpayer's agreement at the most is like a promise not to engage in a certain business and that is not "a conveyance of property" and the payment received therefor is not "proceeds received on disposal of a capital asset." *Beals' Estate* v. *Commissioner,* 82 F. (2d) 268, 270 (C. C. A. 2).

## CONCLUSION

It is submitted that the decision of the Board of Tax Appeals is correct and should be affirmed.

Respectfully submitted,

SAMUEL O. CLARK, JR.,
*Assistant Attorney General.*

J. L. MONARCH,
HARRY MARSELLI,
*Special Assistants to the Attorney General.*

OCTOBER, 1941.

## APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 21. NET INCOME.

"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

* * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has

not taken or is not taking title or in which he has no equity.

* * * * *

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

* * * * *

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

* * * * *

PART IV—*Accounting Periods and Methods of Accounting*

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income.

* * * * *

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the dividends paid credit provided in section 27) provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.

* * * * *

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

(A) for expenditures, receipts, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;

* * * * *

Sections 21, 22 (a), 23 (a), 24 (a) (2), 41, and 43 of the Revenue Acts of 1928 (c. 852, 45 Stat. 791), 1932 (C. 209, 47 Stat. 169), and 1934 (c. 277, 48 Stat. 680), contain provisions similar to those above quoted.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

> ART. 23 (a)–1. *Business expenses.* — Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, * * * Among the items included in business expenses are management expenses, commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see article 23 (a)–2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. * * * The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business. As to items not deductible under any provision of section 23, see section 24.
>
> ART. 24–2. *Capital expenditures.*—Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. (See section 23 (1).) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. The amount expended for architects' services is part of the cost of the building. Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities, when such commissions are not an

ordinary and necessary business expense, are an offset against the selling price. Expenses of the administration of an estate, such as court costs, attorneys' fees, and executors' commissions, are chargeable against the corpus of the estate and are not allowable deductions. Amounts to be assessed and paid under an agreement between bondholders or shareholders of a corporation, to be used in a reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income. (See article 22 (a)–17.) An assessment paid by a shareholder of a national bank on account of his statutory liability is ordinarily not deductible but, subject to the provisions of the Act, may in certain cases represent a loss. Expenses of the organization of a corporation, such as incorporation fees, attorneys' and accountants' charges, are capital expenditures and not deductible from gross income. A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stock holdings in the subsidiary may not deduct amounts paid in carrying out this guaranty in computing its net income, but such payments may be added to the cost of its stock in the subsidiary.

ART. 41–3. *Methods of accounting.*—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. (See section 54 and article 54–1.) Among the essentials are the following:

*  *  *  *  *

(2) Expenditures made during the year should be properly classified as between capital and expense; that is to say, expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account;

* * * * *

ART. 43–1. *"Paid or incurred" and "paid or accrued."*—(a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48 (c).) The deductions and credits provided for in Title I (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commisioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Act, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

* * * * *

ART. 43–2. *When charges deductible.*—Each year's return, so far as practicable, both as to

gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his account. * * *

ART. 113 (b)–1. *Adjusted basis: General rule.*—* * * The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. * * * In the case of unimproved and unproductive real property, carrying charges, such as taxes and interest, which have not been taken as deductions by the taxpayer in determining net income for the taxable year, or a prior taxable year, are properly chargeable to capital account.

* * * * *

Articles 23 (a)–1 of Regulations 86 (promulgated under the Revenue Act of 1934), and 121 of Regulations 77 (promulgated under the Revenue Act of 1932), and Regulations 74 (promulgated under the Revenue Act of 1928), contain provisions similar to the above quoted provisions of Article 23 (a)–1 of Regulations 94. Articles 24–2 of Regulations 86 and 282 of Regulations 77

and 74 contain provisions similar to the above quoted portion of Article 24–2. Articles 41–3 of Regulations 86 and 323 of Regulations 77 and 74 contain provisions similar to the above quoted provisions of Article 41–3 of Regulations 94. Articles 43–1 and 43–2 of Regulations 86 and 341 and 342 of Regulations 77 and 74 contain provisions similar to the above quoted portions of Articles 43–1 and 43–2, respectively, of Regulations 94.

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